Dysfunction of resource allocation by market mechanism and State intervention in corrections

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Abstract: Reference system to which it is discussed involvement in the economy market with perfect competition, perfect competition system, characterized by absolute lack of opportunities to influence the price for participating business entities. Neoclassical economics has shown that market with perfect competition ensures optimum identity - efficiency - balance. In reality, the functioning of free market competition on a mecamism imperfect present, to varying degrees, "defective", "gaps" or "failures" complete which result in the removal of optimum-efficiency economy-balance identity and justifying the existence of a compensatory mechanism (correction) of public action. To summarize, in terms of objectives, involvement of the state presupposes that the following roles: allocation role, subordinate goal of efficiency, distributive role, subordinate to the objective of social equity and subordinated to the objective of regulating the role of general equilibrium.

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1. INTRODUCTION

Old reports state research topic - the economy remains always timeliness and attractiveness. Problems and functions of the state, its involvement in the economy, the optimal size of public sector border public sector - private sector, denationalization, privatization, bureaucracy, rationality of public decision etc. occupies an important place both in theoretical dissertations economic and political debate. Explanation is related to the reality of increasing the share of public sector in market economies today, therefore called "mixed economy".

Market economy as it was imagined and described by the classical thinkers, is an economy where the individual, the tendency to selfishness by making good, shall be guided by an "invisible hand" to achieve public good, so any intervention state in the free market mechanism would almost inevitably lead to negative consequences. However, the market economy operates efficiently, that operates within existing resources and ensure maximum satisfaction of needs of consumers, only under conditions of perfect competition. If any, market forces will lead to a competitive equilibrium (Pareto optimal state), in which no one can gain an increase in utility (satisfaction) to a total that does not involve a reduction in utility of another person. Competition which ensures perfect identity is *optimum - balance - efficiency.*

In fact, there is perfect competition and therefore appear a number of situations where the market makes an inefficient allocation of resources, known as *market failure.* The term market failure is understood that any market performance is considered be less good than the best performance possible, what happened does not mean anything good. Due to the presence of market failures in the state may intervene to correct resource allocation or offset market weakness. Allocation of resources is the transformation of productive resources into goods and services consumption. *Dysfunction market allocation* is characterized by prices which expresses or marginal utility costs, by imbalances between supply and demand. The cause of dysfunction, which justifies public action in resource allocation could be the lack of perfect transparency of the market, monopolization of production or demand, technical or natural monopoly, the existence of collective goods and externalities.

Also found that markets always work well in achieving wider social goals such as achieving a fair distribution of income or promoting community values. Markets are not effective in achieving those goals because people do not pursue these goals through the purchase of goods and services. Since the functioning of the market can often be unfair and could lead to huge inequalities, the state may intervene to correct *market dysfunction distribution.*

Also, savings are regularly confronted with a number of imbalances, which generates negative phenomena such as unemployment, inflation, balance of payments deficit, lack of economic growth, etc. In this case, the state may intervene to curb the extreme effects of the economic cycle and achieve *economic stabilization.*

To achieve these roles they can play in economics, Paul Samuelson and William Nordhaus shows that the state has three main categories of instruments: taxes, public spending and regulations[1].

2. CORRECTION RESOURCE ALLOCATION

Phenomena that lead to dysfunction (failure) of that market as there are public goods (collective consumption), merit goods and goods undeserved, externalities (external effects), and the existence of monopoly power.

2.1. A public goods (goods of collective consumption)

Public goods are a special category of goods whose distinction is made by two characteristics: nonrivalitate and nonexcludere[2].

Nonrivalitate property refers to the fact that, after being produced, for any additional consumer is zero marginal cost and therefore the use of a public good by one individual does not reduce the quantity of goods they consume this way and others cut benefits derived from consumption of other individuals reserved.

By nonexcludere means that the property, once produced, there is no way to stop someone to eat. This is due to technical inability to exclude an individual to use public property or high costs of trading.

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[1] P. Samuelson, W. Nordhaus," Economics" 15thedition, McGraw-Hill, Inc., 1995.

[2] T. Moşteanu, "Prices, competitive equilibrium and social welfare", Economic Publishing House, Bucharest, 2001, p. 174, 197-199.

Goods that are fully characterized by two properties are pure public goods such as defense and public lighting. On the opposite side is private property not covered in any way attributable to the two properties. Between these two extremes are a number of joint property is characterized only by one of the characteristics of public goods, such as joint property that is characterized by nonrivalitate technically feasible but exclusion (which shall include highways, bridges, sports fields, pools swimming, parks, etc.) or mixed property which is characterized by rivalry and impossibility of exclusion (which falls under common property resources like pastures, international fishing places and others). Developments in technology can change the character of public goods by the emergence of technical means to exclude or create new goods for which there is no possibility of exclusion. Such situations are encountered for television and highways.

The main problem arises when public goods is the *rider*. If individuals can consume a good without having to pay for it, they will try to consume public goods without paying in the hope that other individuals will bear the costs of providing it. If all individuals adopt the strategy riders will reach the situation where, although could be a mutually beneficial exchange, public goods do not come to be offered on the market. In addition, riders will adopt the strategy that people are not encouraged to reveal their true preferences.

Therefore, in this case there are sufficient arguments for the government to become supplier for public goods type nonexcludere and this activity through taxes, is in the interest of all paying taxes to finance these assets, if taxes are set on a appropriate.

In the case of pooling resources, the best way of state intervention is that of legal regulation, the role of fiscal policy that is eventually to cover the costs of management and conservation of shared resources.

Particular attention should be paid but accurate identification of public goods that must be produced by the State as joint property where there is technical possibility of exclusion can be produced very well and the market system, such as highways, television, stadiums, parks entertainment etc. Coexistence of market and state failure (to be described later) for mixed public goods and require a careful analysis of existing conditions to give an answer to two important questions:

1) What should the government funds to finance the production of public goods or mixed?

2) Who should provide public goods or mixed: government, private sector, voluntary sector or all together?

There are no definitive answers to these questions, the answers can be given for each case only after a thorough examination of the efficiency with which these goods are produced by each alternative.

2.2. Merit goods and goods undeserved

Merit goods are those goods for which the private costs of production do not coincide with the social setting a price below market value which they have on society. Because they are thought to be widely available because they bring benefits, the government requires or encourages people to eat. In this category of goods may include: education, goods and services such as art, fire guards, safety belts for drivers and others.

Role of the State in this case is to provide the necessary funds to support these activities, but the big problem is that of determining the extent to which the state must help

fund these activities, especially since it is very difficult to determine the size of such external benefits.

For some of them, the state provides full funding as if guarding against fires in most countries, while others may require a minimum level of consumption regardless of consumer income, providing finance that level of consumption, such as compulsory education or of vaccinations.

However, there are situations in which private benefits resulting from consumption of these goods are high and people are willing to purchase their own market, not that they need to be provided by the state. This occurs in education, where private education may be an important or of goods and services where there are artists and artistic institutions, artists manage to finance themselves and sometimes even succeed financially. In these cases there is no need full funding from the state, it must only intervene in certain situations, to avoid exclusion from the low income consumer, such as scholarships or loans for poor students study.

To what extent should the state fund the production and consumption of these goods is a question the answer varies from case to case and can not be made until a thorough investigation. However, it is necessary that, where individuals are keen to acquire the assets in private market system, the state should not take it that the delivery of state failure because of problems.

Undeserved goods are harmful to health, for which the government is taking measures to discourage consumption, considering that individuals are unaware that they suffer from their consumption. This includes drugs, tobacco and alcohol.

Most often, the justification for state intervention, it raises a paternalism, it must behave towards its citizens behave as parents to children, ie to protect against their own weaknesses.

Assumption that people can make choices absurd, but contradicts the assumption of rationality adopted in current economic theory. And the idea that the whole society or the state can deliver value judgments on the actions of an individual, considering them irrational, incompatible with a commitment to support the idea of individual liberty. L. Balcerowicz therefore considers that there is a stronger justification: those who consume such products are, unwittingly, a danger to others. Limiting the consumption, the state protects some of threats from others[3].

There are several ways the government can try to stop the consumption of such goods. But prohibition is not the best solution, a good example in this regard is the imposition of prohibition on alcohol consumption in the U.S.

A better solution is to use fiscal *policy*, the imposition of taxes that increase the price of products (is this the tobacco and alcohol), thus discouraging their consumption. An advantage of this method is that it would particularly affect young people whose consumption would be reduced further because they are generally lower income.

In practice, this problem takes the form of application of excise duties on tobacco and alcohol. The solution has the advantage that, besides reducing the consumption of these products bring additional revenue to the state budget. The excise duties on these products has yet to find an optimal level of taxation, because, although these products generally have an inelastic demand, applying a high level of excise duty may lead to

[3] L. Balcerowicz, "Freedom and Development. Free market economy", Publishing Company, Bucharest, 2001, p. 157.

increased tax evasion, production and marketing of goods passing such a large part in the underground economy.

2.3. Externalities (external effects)

In 1973, James Meade[4] concept of *externality* defined as: an external economy (or a dezeconomie) is an event which confers an appreciable benefit (or causing a considerable loss) a person or group of persons when those persons not were found among the parties gave their consent all the decision or decisions reached by directly or indirectly, in the event in question[5]. In other words, the externality occurs when someone (third party) is affected by the decision (decisions) of others. Externalities can be positive or negative.

We are dealing with a *positive* externality when the decision (decisions) produces beneficial effects of certain people over others. Thus the decision to vaccinate a person against a particular disease, giving them the benefit of others that are far less likely to catch. Many elements of the health care system is often seen in this light. Similarly we are dealing with a negative externality when the decision (decisions) of one or more persons adverse effects on others.

Such a situation arises where the decision to dump on the floor, giving rise to an uncouth appearance and a plea of inconvenience for other pedestrians. Environmental issues can be considered as occurring exactly in this context negative externalities.

If *negative externalities,* the essence of the problem may be viewed as a discrepancy between the benefits and social costs and private. So, externalities arise when a number of benefits and external costs, even if its added benefits and costs of a given activity, forming social costs and benefits, they are not reflected in market prices that are causing overproduction or under-production for that object. For example, the fact that companies are not required to pay directly for the cost of pollution created due to the production process you use, make private costs to be below the actual costs borne by society, leading to a lower market price than needed in case the optimal level of production. Thus, both demand and supply will be too high, can be done in an overproduction and overconsumption, ie a situation where resources are not used in the best manner possible. From this, it can be concluded that the environmental problem is based on not including the cost curves of the environmental harm caused by private firms.

Fiscal policy can be used to address negative externalities state by introducing a pollution *tax* to be used to increase costs to producers externalității negative value, thereby increasing the firm's private costs up to the real social cost.

As a result, the production volume will reach down to the optimum level, thereby realizing an efficient production office. The solution proposed by Arthur Pigou, who suggested the possibility of using grants for the same purpose. The government may decide to pay an operator for each output polluter is not produced, thus limiting the production of up to a socially efficient. Also the government can subsidize the costs of reducing pollution. It is also possible to use subsidies in case of positive externalities, to encourage their greater output.

Introducing such a tax, except that it will reduce the volume of production at optimum level for society, has the advantage that will generate revenue for the state, which

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[4] James Edward Meade (1907-1995), British economist, Nobel laureate for economics in 1977.

[5] Quoted by Stephen C. R. Munday, "Avant-garde ideas in economics", Codecs Publishing, Bucharest, 1999, p. 117.

could be used to compensate for damages caused to those who had suffered pollution, thus further supporting the case for the imposition of such tax.

However it should be noted that there are many practical problems related to introducing this type of tax, because it is very difficult to calculate an appropriate level of taxation and the estimated size of the damage caused to third parties (external marginal cost). A good example is the pollution caused by cars. Corrective tax rule should be fixed per kilometer, but it is unfeasible management of such tax. As a result, most countries use substitutes such as special taxes levied on the sale of machinery, fuel taxes and annual tax on vehicles, which are theoretically most effective. Also, in case of market distortions due to monopoly or oligopoly, such a solution might not be optimal, because due to market imperfections, the marginal cost can not be equal to the price. Final solution is likely to become less desirable than the original position of the market, where no tax due to strong price growth.

Another solution can be applied to the problem of negative externalities is *regulation, the* government can adopt legislation by requiring each agent to reduce pollution within limits. This method raises a number of difficulties related to the high costs of monitoring compliance with legal regulations, it is difficult to apply when there is a large number of polluting firms and tracking down a large number of pollutants. In addition, to consider that by this method, which requires firms to make reductions in the emission of pollutants equal, it can reach very high average cost for a unit reduction in emission of pollutants. The same reduction in emission of pollutants can be achieved with much lower costs, if one takes into account that for some operators to reduce cost per unit of pollutant is lower than for other operators, is more beneficial use permits marketable.

Choosing the best choices of the set is a difficult operation, which should take into account the benefits and high costs of each method. Most economists prefer the economic approaches such as taxes and subsidies, which are much cheaper remedy against a negative externality than administrative regulation or prohibition. It is estimated that in some cases economic solution costs only a tenth of the price of administrative actions. However, it should be excluded or combined use of these methods as a way to increase the scope, especially in combating the negative externalities related to environmental pollution.

2.4. Monopoly power

Monopolies, cartels and pricing agreements among oligopolists, either explicit or tacit, faced over time both with suspicion as public and official hostility. These and other practices are called noncompetitive monopoly practices, and more than one hundred years governments, through laws and other tools, have intervened to encourage competition and discourage monopolistic practices. The reason is that monopolies restrict output to obtain higher prices and hence the monopoly is inefficient allocation of resources, preventing him obtain a Pareto optimum.

However, there is a situation in which the state accepted the existence of monopolies, namely *the natural monopoly (technically).* In this case, technically speaking, a monopoly is more efficient than the competition because of economies of scale. It occurs where the private nature of goods produced favor monopolization of production such as the production and distribution of water, gas, electricity etc.

Initially, when natural monopolies state occurred mostly in the form of nationalization, the owner taking over these companies and became provider as the state

tries to provide these services at lower prices than those that existed on the market for operation of private monopolies. This is because the rule was not intended to maximize profits but to adopt alternative management such as management in equilibrium.

In many countries were nationalized, in addition to natural monopolies and a number of industries that operate as oligopolies such as airlines, railways, steel, mining. This was because the control of natural resources and industries - was considered a key prerequisite for growth and ensure public ownership best control.

Because, most times, these businesses have operated at a loss, showing a weak economic efficiency, the state had to intervene to cover losses through budgetary resources. In addition, often the management of some of these companies, the state sought and ensuring fairness in social, subsidizing many services to enable their use by those with low incomes. As a result, substantially increased public expenditure in this area, which has also led to increased taxation.

Since the '80s, almost all advanced industrial nations and the vast majority of least developed nations began to reduce the level of government control over industry, demarând privatization process which resulted in large public enterprises have been transferred to private ownership, considering is sufficient normative regulation of their activities. The bodies that were established to control the activity of natural monopolies and establish norms and rules they must lead, in many cases regulations set the prices that even the business world may require their services.

Key to the regulation of natural monopolies is to establish a corresponding set of rules that give companies the right incentives to behave efficiently. In Britain, for example, the main rule established for private providers of public services is the so-called rule IPR-X, which allows them to increase prices with the difference between the rate of inflation (retail price index-IPR) and a reasonable rate productivity growth (denoted by X). This gives companies an incentive to increase efficiency through cost reductions.

Regarding the state's role in natural monopolies, it is possible to use system taxes to bring the cost closer to the price level. Unfortunately, information needed to reach the correct equation is very complex, and intervention by governments usually choose as the most effective legislation is by establishing price fixing rules.

3. THE POSSIBILITY OF FAILURE OF STATE INTERVENTION

Analysis on the most appropriate level of state involvement in the supply of goods and services in an economy must not omit the existence of the concept of *state failure*. Failure occurs when government intervention is not the desired effect or cause unwanted side effects, or both.

One of the major difficulties facing the government, whatever form it chooses to intervene to tackle market failure refers to the amount of information necessary to make the right decisions. As a result of this requirement, a very large amount of resources must be allocated to obtain relevant data, which can lead to *a high degree of bureaucracy government*, not directly contribute to creating utility. In addition, it is possible emergence of a class of bureaucrats, which seeks its own specific targets within the system, which implies that achieving economic efficiency ceases to be a priority. Considering the fact that relevant information will never be fully tightened, there is a high possibility of making wrong decisions and lack of accuracy.

Friedrich Hayek showed that in a world where information is imperfect and dispersed, the market fails to achieve an allocation of resources with a minimum of

information needed, while for the state can do so requires a huge volume of information and that he thought that the supply of goods and services should best be left to the free market.

Another example of failure of government intervention brought by public choice theory, which shows that *politicians can pursue personal interests first* and not the public interest. Therefore it seems perfectly reasonable to believe that they could try to determine the regulation of government intervention in the economy for his own use rather than for the good of society as a whole. An important example of this is political and the economic cycle, which shows that the main concern of politicians is a concern to be re-elected, and another example is corruption. In these circumstances it is quite possible that primary concern of government, when there is the economy, not to be to cause a greater degree of efficiency.

Another important question posed by government intervention as the vendor is that the public can become vulnerable to the influence of powerful interest groups. In this sense, Mancur Olson states that the struggle for the allocation of resources between competing interest groups that are pressing the state to get some benefits: protection from competition from other bidders, grants from budget. A large number of such groups may hinder economic development, because their action is a form of social waste energy, time spent to lobby can not be used simultaneously to optimize their economic activities. The result of this time consuming, is in turn damage, the economic unit is transformed into a motley accumulation of conditions that depend on the strength of political pressure.

A final problem of state intervention in business to supply goods and services relates to the *rigidity of the legislation.* Thus, rules and regulations are difficult to change, while market conditions change continuously and often rapidly. An example is that because of technological change for a range of services at one time considered natural monopolies, the market has become competitive, such as telecommunications and even rail transport. However, some governments still tend to cover those areas work.

As a result of these potential failures of the state, critics warn that government intervention may have more harmful effects on society than the "invisible hand" of market and produce public goods instead of social utility, can cause more serious distortions than the correction which occurred.

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